

## 4.8 The balance between markets and intervention

### Learning Outcomes

- Discuss the positive outcomes of market-oriented policies (such as liberalized trade and capital flows, privatization, and deregulation), including a more efficient allocation of resources and economic growth.
- Discuss the negative outcomes of market-oriented strategies, including market failure, the development of a dual economy, and income inequalities.
- Discuss the strengths of interventionist policies, including the provision of infrastructure, investment in human capital, the provision of a stable macroeconomic economy, and the provision of a social safety net.
- Discuss the limitations of interventionist policies, including excessive bureaucracy, poor planning, and corruption.
- Explain the importance of good governance in the development process.
- Discuss the view that economic development may best be achieved through a complementary approach, involving a balance of market-oriented policies and government intervention.

Some economists argue free markets are necessary for economic growth and development and that government intervention in markets is a barrier to growth and development.

### What are the implicit assumptions of the theory of free markets?

Consumers and producers are self-interested and they are maximizers. Producers aim to maximize profit and consumers aim to maximize **utility** from their scarce income. Some economists argue that when consumers and producers pursue their own self-interest, social welfare will be maximized.

### Explain how social welfare is maximized when consumers and producers pursue their own interests

Price plays an important role in a free market economy. If utility from the consumption of a good increases **quantity demanded** of the good increases at each price. When demand increases for a good **equilibrium price** must increase in order to remove the excess demand. As price rises, *ceteris paribus*, profit at each price increases therefore firms allocate more resources to the production of the good, thereby increasing output in order to increase profit. Demand and supply is in equilibrium, therefore **consumer surplus** and **producer surplus** is maximized. In other words, **consumer welfare** and **producer welfare** is maximized. The sum of producer and consumer welfare is called social welfare. If price changes in response to changes in demand and supply then resources will be allocated to the production of goods and services that maximize social welfare.

In competitive markets firms compete with other firms in the industry, leading to price competition. Firms must keep their **costs of production** as low as possible so that they can compete at the market price. This means that firms in a competitive industry must be **productively efficient** in order to survive in business. That is, they must produce at the lowest possible average total cost. Therefore, each good is produced using the minimum amount of resources. This leaves more resources available to produce other goods, increasing the number of goods that can be produced from a given quantity of resources thereby increasing social welfare.

### Does trade liberalization increase social welfare and economic development?

Governments intervene in markets in order to protect domestic firms. Governments of developing countries that are trying to industrialize pay subsidies to domestic manufacturing industries and place tariffs on imported manufactured goods. This policy is called import substitution. Governments can also devalue their currency in order to make their exports more price competitive. This policy is called export promotion. (See pages 201–206 for a detailed explanation of the welfare loss caused by protectionist policies such as subsidies and tariffs.)

Free market economists believe that when governments put up barriers to trade it causes welfare loss. More of the world's scarce resources are used to produce a given quantity of goods than is necessary. If each country produced goods in which they had a **comparative advantage** total world output would increase. If the countries traded then the citizens of each country could consume more goods thereby increasing welfare. (See pages 196–201 for a detailed explanation of the gains from trade arising from absolute and comparative advantage.)

### Subject vocabulary

**utility** a term that refers to the benefit or satisfaction a person receives from the consumption of goods

**quantity demanded** the amount of a good consumers are willing and able to buy at a given price over a given period of time

**equilibrium price** the price at which the quantity consumers are willing and able to buy is equal to the quantity firms are willing and able to produce

**consumer surplus** the difference between the price a consumer is willing and able to pay and the price the consumer actually pays

**producer surplus** the difference between the price a firm is willing to accept for a unit of output and the price the consumer actually pays

**consumer welfare** a measure of the benefit obtained from the consumption of goods

**producer welfare** a measure of the benefit gained by a firm from the sale of goods

**costs of production** the amount the firm pays for the factors of production used to produce goods or services

**productively efficient** a firm that is producing goods at the lowest average cost

**comparative advantage** when a country, firm, or individual is able to produce a particular good or service at a lower opportunity cost than other countries, firms, or individuals

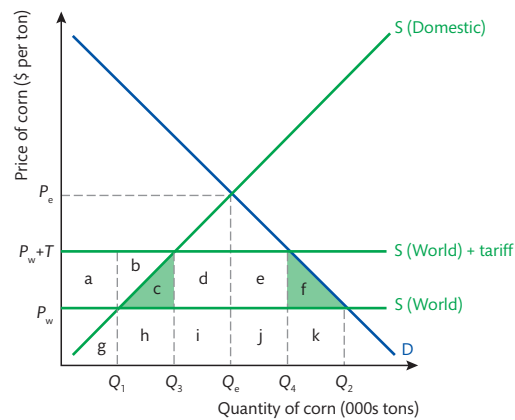


Figure 86.1

The less efficient domestic producers now supply more corn and the more efficient foreign producers supply less corn. More of the world's scarce resources are being used to produce a given output of corn than is necessary.

Consumers pay a higher price for corn thereby making them worse off. Areas c and f represent overall welfare loss. **Protectionism** may lead to a net fall in the welfare of the people of the developing country.

However, with more people working in the domestic industry, and the tariff on imports, the government collects more tax revenue, which can be spent on education and health thereby improving economic development.

**Model sentence:** Removing a tariff reduces the price consumers pay for goods increasing consumer surplus and the purchasing power of their given income. Consumers can buy more goods and therefore satisfy more wants thereby increasing their welfare.

The aim of import substitution is to protect infant manufacturing industries. Subsidies are paid to the manufacturing industry that in effect reduces the industry's costs of production and increases supply. Domestic producers now produce more goods and fewer goods are imported. Less efficient firms produce more goods and more efficient firms produce less. More of the world's scarce resources are used to produce a given output of goods than is necessary.

The price the consumer pays does not change, so there is no loss of consumer surplus, but the subsidies are paid from tax revenue. Taxes might have to increase to pay for the subsidies leaving consumers with less **disposable income**.

**Model sentence:** There is an **opportunity cost** of a subsidy. The tax revenue spent on the subsidy cannot be spent on education and health thereby harming economic development.

However, if the industry is protected it can grow. Unemployment falls and incomes increase over time. Once big enough the industry benefits from **economies of scale** lowering average total costs. The domestic industry is now able to compete with foreign producers on price. Then the subsidies can be removed.

**Model sentence:** In the long-term import substitution leads to an increase in domestic industry profits and employment and therefore an increase in tax revenue. The developing country can end its dependence on the production of **primary goods** thereby increasing **export revenue**.

Economic development might be improved by **trade liberalization** but this depends on the relative strengths in the long-term of the advantages and disadvantages of import substitution and export promotion.

## Does privatization and deregulation lead to an increase in social welfare and economic development?

Privatization is denationalization. It occurs when the ownership of an industry or firm is changed from state ownership to private ownership.

State-owned industries often make a loss. Government subsidies, paid out of tax revenue or government borrowing, are required to pay for the loss leaving less revenue to spend on education and health thereby

### Subject vocabulary

**protectionism** government policies, including tariffs, quotas, and subsidies, that restrict the extent of international trade and which are implemented in order to protect domestic industries from cheaper imports

**disposable income** household income after direct taxation has been deducted

**opportunity cost** the next best alternative forgone

**economies of scale** the cost advantages gained by a firm from increasing the scale of its production. Average cost falls in the long run as the size of a firm's operation increases.

**primary goods** a good that has not been processed and is in a raw state (e.g. fruit/wheat)

**export revenue** income that flows into a country from the rest of the world from the sale of its goods and services to foreign buyers

**trade liberalization** the removal of, or reduction in, the international barriers to trade, such as tariffs and quotas

harming economic development and possibly increasing the national debt of the developing country.

Private businesses that are inefficient and produce at relatively high average total costs go out of business in the long term. However, loss-making, state-owned industries are subsidized because the government wants to protect jobs. The management of state-owned industries know that the government will continue to pay the losses so there is little incentive to use factors more efficiently and become more productive in order to lower average total cost.

**Model sentence:** Loss-making private firms will not survive in the long term if average total cost is not reduced. Privatization of loss-making state-owned firms therefore leads to improvements in productivity.

After privatization fewer resources are needed to produce a given quantity of goods and tax revenue will increase when profits are made, adding to total tax revenue. The additional revenue can be used to improve educational and health services thereby increasing economic development.

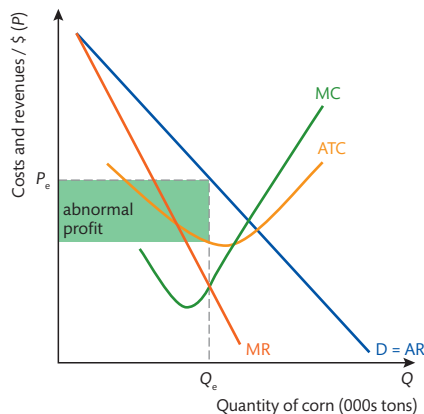


Figure 86.2

Deregulation occurs when barriers to entry into an industry are removed or reduced, making the industry more contestable. New firms can enter the industry, thereby increasing competition and industry supply. An increase in supply drives price down, thereby increasing consumer surplus. With increased price competition firms have the incentive to increase **productivity** in order to lower average total cost. In this way fewer resources are required to produce a given quantity of goods.

However, state monopolies have been brought into private ownership. With no competition and high **barriers to entry** the private monopolist reduces supply in order to increase price and earn **abnormal profit** as shown in Figure 86.2. This causes a misallocation of resources and a loss of welfare.

**Model sentence:** Privatization of an industry can lead to a more efficient use of resources, increases in productivity and a reduction in tax revenue used to pay subsidies. However, if the industry gains monopoly power privatization can lead to higher prices and welfare loss.

### Subject vocabulary

**barriers to entry** factors that prevent/make difficult the entry of new firms into an industry or market

**abnormal profit** occurs when economic profit is greater than zero, i.e., when total revenue is greater than total cost (explicit and implicit costs)

**productivity** the quantity of output per unit of input

**factors of production** the inputs into the production process (land, labour, capital and entrepreneurship)

**capital** manufactured goods that are used in the production of other goods

**opportunity cost** the next best alternative forgone

## What are the effects of capital flows on economic growth and development?

Long-run economic growth is an increase in the potential output of an economy. It is caused by an increase in the quantity and quality (productivity) of the **factors of production**. In order to be able to grow, a country must save in order to invest. Fewer consumer goods need to be consumed today in order that resources can be used to increase the quantity and quality of **capital** so that more goods can be produced in the future. In other words, less consumption today means more can be consumed in the future.

The **opportunity cost** of investment is the benefit forgone from the present consumption of consumer goods. However, levels of income are very low in LDCs. Most people are poor and must spend 100% of their income in order to satisfy basic needs. It is not possible to raise enough funds for investment because savings are very low. People with higher incomes in LDCs often invest in foreign developed countries because of the higher rates of return and lower risks. Investment funds flowing out of a country is called capital flight.

LDCs are over-dependent on the production of primary goods, the price of which is falling in the long-term. Export revenue needed to buy imported capital is therefore falling, making progress towards industrialization very slow.

**Model sentence:** LDCs are stuck in the poverty cycle of low income, low savings, low investment, low growth, and low income and so on. To break free from the cycle, LDCs need inward investment.

Foreign direct investment (FDI) is an injection of investment capital from one country into the economy of another country (see pages 267–69 for a detailed evaluation of FDI). FDI can increase the rate of industrialization, reduce unemployment, increase income and tax revenue, and break the LDC's dependency on primary goods.

## Subject vocabulary

**negative externalities** occur when the production or consumption of a good creates costs that must be paid by third parties. The existence of negative externalities means that social cost is greater than private cost.

**natural resources** assets, such as mineral deposits and timber, that occur in nature and can be used in production

**economic growth** an increase in real GDP

**allocatively efficient** the best or optimal allocation of resources from society's point of view. It occurs when the market is in equilibrium and social surplus is maximized (where  $P = MC$ ).

**external benefits** occurs when the production or consumption of a good causes a benefit to third parties

**external costs** occurs when the production or consumption of a good creates a cost that must be paid by third parties

**free rider problem** occurs when people are able to benefit from the consumption of a good or service without paying the full price or without paying any money at all. The good will be under-provided or, in the case of a pure public good, not provided at all.

**monopoly power** the degree of control a firm has over the setting of price

**marginal cost** the change in total cost resulting from a change in output of one unit

**profit/economic profit** the difference between total revenue (price  $\times$  quantity sold) and economic costs (explicit costs + implicit costs)

**utility** a term that refers to the benefit or satisfaction a person receives from the consumption of goods

**private costs** the cost incurred by firms or consumers from their own production or consumption of a good

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## Synonyms

**implied**..... suggest/indicate

## Glossary

**respiratory** related to breathing/the lungs

However, workers in the new industries are often paid very low wages. Most of the income earned is in the form of profit, and much of this flows out of the country to the foreign owners.

Industrial output creates **negative externalities** and the country's **natural resources** can be overused harming the future potential levels of output and income.

Capital-intensive methods of production are often used by foreign firms in LDCs. LDCs have a large surplus of low skilled workers. The use of capital-intensive methods limits the positive effects that FDI has on employment, wages, and **economic growth**.

A large firm investing in a LDC benefits from economies of scale and can produce at low average total cost. Small domestic firms are unable to compete and go out of business. The economies of scale are a barrier to entry which has the effect of reducing entrepreneurial activity.

The negative outcomes of free markets are discussed below.

## Explain why free markets can lead to market failure

A free market is not necessarily **allocatively efficient**. Sometimes governments must intervene in markets in order to increase market efficiency. Left to the free market some goods are under produced and some are over produced. A market can fail when producers have monopoly power, when production creates **external benefits** or **external costs** and when the market does not exist because of the **free rider problem**. (See section 1.4 for a detailed explanation of market failure.)

## Why does monopoly power lead to market failure?

(See pages 85–93 for a detailed explanation of the effects of monopoly power.)

Large multinational companies (MNCs) benefit from economies of scale and have strong brands. When an MNC invests in a developing country it has **monopoly power** in the market. New domestic firms cannot compete in the industry because of the high barriers to entry and existing domestic firms are driven out of the industry because their average total costs are too high.

The MNC restricts output to  $Q_m$ , as shown in Figure 86.2 (page 285), in order to increase revenue and profit. At this level of output the price is greater than **marginal cost**. That is, the value that consumers in society place on the consumption of the next unit is greater than the value of the resources used to produce it. There is a misallocation of resources and a loss of welfare due to monopoly power. Society's welfare would be increased if more factors were allocated to the production of the good.

## Why does the existence of externalities lead to market failure?

(See the units on market failure for a full explanation of the effects of externalities.)

The **implied** assumptions in economics are that humans are self-interested and they aim to maximize their benefit. Producers want to maximize **profit** and consumers want to maximize their **utility** from their scarce income. When producers make decisions concerning the level of output they only consider their **private costs** and **private benefits**. When consumers decide on how much to consume they only consider their private costs and private benefits. Producers and consumers do not take into account the external benefits and external costs when deciding upon levels of production and consumption.

There are external benefits that arise from the consumption of education and healthcare. These are benefits that are enjoyed by third parties. An external benefit of these two **merit goods** is the increase in national income caused by an increase in the **value of human capital**. If left to the free market education would be under produced and under consumed and society would not gain the external benefits that arise from a well educated labour force. Those on low income would not be able to afford to buy an education for their children, therefore many children would also not gain the private benefits from education, leading to an inequitable society. Parents do not take into account the external benefits when deciding how much education to buy for their children, therefore the amount of resources allocated to education is not at the social optimum level and the market fails.

Industrialization can cause a market to fail. Firms, for example, do not take into account the external costs caused by pollution, particularly if laws governing emissions from factories are not strong. In China industrialization has led to an increase in air pollution leading to a rise in **respiratory** diseases. The external costs are high – many people are ill and cannot work reducing potential output of the economy and there are costs of healthcare that must be paid – output is therefore above the **social optimum level of output** and the market fails.

## Why does the free rider problem lead to market failure?

Left to the free market, supply of some goods will be zero. Some goods are non-excludable and non-rivalrous. A good is non-excludable when once supplied by a firm people cannot be stopped or excluded from gaining the benefits available from consuming it. A good is non-rivalrous when consumption of it by one person does not reduce the amount of goods available for others to consume. In this situation there is no incentive for the consumer to pay so they will free ride, in the hope that others will pay. Because people will not pay, firms are unable to make a profit and therefore do not produce the good. Goods that are non-excludable and non-rivalrous are called pure public goods. National defence and street lights are examples of public goods.

**Transport infrastructure** is an example of a **quasi-public good**. It shares similar characteristics of pure public goods. Although it is possible to exclude people from using roads once provided there is no doubt that left to the free market the resources allocated to the construction of roads would not be enough to build a social optimum number of roads. Government expenditure is needed to increase output to the social optimum level thereby correcting market failure.

## Why might free markets lead to market failure and an inequitable society in LDCs?

The level of skills and education in an LDC are low. The quantity and quality of the infrastructure, including transport systems, communication networks, schools, and health services are also low. There are many external benefits gained from these goods but left to free markets they would be under supplied thereby limiting economic growth and development.

It is argued by most economists that the government must intervene and make the investments necessary to increase economic growth and development. Society would also be less equitable without government intervention. For example only those who can afford education, training, and health services will be able to earn higher incomes, particularly in LDCs where highly skilled workers are in short supply.

Labour is the only asset owned by most people living in a LDC. There is a **surplus** of low skilled workers which pushes down the wage (income) that is earned from the asset. Left to the free market, without government investment in education and training, many people will continue to live in poverty while those few who are highly skilled, and those who own capital, earn higher incomes. The higher income can be used to purchase assets such as property, **saving accounts**, and **shares** which also generate income streams. In this way income distribution becomes more unequal and society becomes more inequitable.

**Model sentence:** Education, training, and health services generate external benefits that lead to an increase in economic growth and economic development. Left to free markets the market for these services would fail therefore the government must intervene.

## What is a dual economy?

A dual economy occurs when two separate economic sectors exist in one country. For example, it occurs within a country which has a large rural agricultural sector and an urban industrial sector. A dual economy can come about through the introduction of import substitution and export promotion.

In time the demand for labour in the industrializing urban sector pushes up wages, leading to a poor rural population and a relatively richer urban population. Income distribution becomes more unequal. By focusing on industrialization most investment is centred on the expanding industrial sector, so little is left for investment in the agricultural sector leading to unbalanced economic growth.

A dual economy can also exist within one sector. For example when part of the agricultural sector uses **advanced technological capital** and the other part uses old, traditional farming methods.

## What is unbalanced growth?

Unbalanced growth occurs when a country focuses investment in one sector. Some economists argue that governments of LDCs should follow an unbalanced growth strategy. For example an LDC does not have enough investment funds to invest in all sectors, therefore should focus investment on expanding the industrial sector. The industrial sector will therefore grow at a faster rate than the other areas of the economy.

As the sector expands, and supply increases, it creates demand for other goods and services. Firms that supply the growing industrialized centres will benefit from increased demand and the growing industrial centres will

### Subject vocabulary

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**private benefits** the benefit firms or consumers receive from their own production or consumption of a good

**merit goods** goods that the government believes will be under consumed left to the free market. Consumption of a merit good may generate positive externalities therefore the social benefit of consumption is greater than the private benefit.

**value of human capital** a measure of the quantity and quality of the skills of the labour force that can be employed to produce goods and services. An increase in the value of human capital leads to an increase in labour productivity.

**social optimum level of output** the level of production or consumption where marginal social benefit is equal to marginal social cost

**transport infrastructure** the physical capital that supports a transport system such as roads, railways, ports, airports

**quasi-public good** goods that share some of the characteristics of public goods but are not fully non-excludable and non-rivalrous. A road is an example. Most roads are free at the point of use but it is possible to make people pay through tolls and when traffic is heavy the amount available to others to use does begin to diminish so there can be rivalry in consumption.

**surplus** occurs when quantity supplied is greater than quantity demanded, another term for excess supply

**saving accounts** a bank account which pays interest on deposits

**shares** a unit of ownership of a company's capital. The owner is entitled to a proportion of the company's profit.

**advanced technological capital** capital that incorporates new technology and is used in place of existing capital to produce goods and services, thereby increasing productivity



## Subject vocabulary

**import substitution** the promotion by government of domestic industries by protecting domestic producers

**infant industries** a new industry which often is not able to compete against established foreign industries and therefore needs to be protected from the competition through subsidies and tariffs

**current account balance** the sum of the value of exported goods and services, minus the sum of the value of imported goods, plus net income from abroad and net current transfers

**comparative advantage** when a country, firm, or individual is able to produce a particular good or service at a lower opportunity cost than other countries, firms, or individuals

**labour-intensive industries** industries that in production require a large amount of labour relative to the amount of capital

**subsidies** payments made by government to firms per unit of output

**nationalization** the process by which a government takes ownership of a private firm or industry

**fiscal policy** government policy designed to achieve macroeconomic objectives through government expenditure and taxation

**monetary policy** the control of the supply of money by the central bank to affect the economy (e.g. changing interest rates)

**contractionary fiscal policy** policy involving the reduction of government spending and/or the increase of taxation

**contractionary monetary policy** policy involving the reduction of the money supply and the increase of interest rates

**aggregate demand** the total demand for goods and services in the economy at a given price level in a given period of time

**devaluation** the official lowering of the value of a country's currency in a fixed exchange rate system

## Glossary

**sanitation** the removal/treatment of waste/water

demand infrastructure, such as transport and communication networks. As demand rises, prices and profits increase, leading to an increase in entrepreneurial activity and an increase in new firms entering the market.

Through investment in a few industrializing centres and a policy of **import substitution** the developing country can protect the **infant industries** from foreign competition, thereby replacing the consumption of imports with the consumption of domestically produced goods thereby improving the **current account balance**.

Economists who support unbalanced growth argue that the government must intervene in free markets. Governments should direct investment into industries in which the country has a **comparative advantage**. LDCs have a surplus of low skilled workers, therefore investment should be focused on **labour-intensive industries**, such as the textile industry, and the government should protect the industry using **subsidies** until the industry has grown and the subsidies can be removed.

State intervention is limited to encouraging the growth of a particular sector, after which free market forces are allowed to operate so that as demand increases higher prices and profits attract further investment, leading to an increase in the allocation of resources and economic growth.

## What is balanced growth?

Balanced growth occurs when different sectors of the economy grow at similar rates. The government of an LDC must intervene if balanced economic growth and development is to be achieved. The government increases taxes to provide investment funds for the **nationalization** of industries, subsidies to firms, and the provision of infrastructure necessary for growth. By spreading investment across different sectors the benefits of growth are not focused on just one sector. Balanced growth requires much greater government intervention. The government centrally coordinates and allocates the country's scarce resources so that the economy can achieve balanced growth.

## What are the strengths of interventionist policies?

The strengths and weaknesses of interventionist policies are discussed below.

As demand increases for a good price, and profits rise, this leads to an increase in the quantity of resources allocated to the production of the good in order to increase output. When demand falls price and profits fall leading to a fall in the quantity of resources used to produce the good. It is the price mechanism that determines how resources are allocated in a free market.

The government may intervene in the market to achieve a different allocation of resources. Government may intervene in order to correct market failure caused by externalities or to create a more equal distribution of income or to achieve its macroeconomic objectives.

As discussed previously, without government intervention education, training, and healthcare would be under provided and under consumed. Left to the free market many people would go without these essential services thereby limiting economic growth and development and causing a very unequal distribution of income.

Transport and **sanitation** infrastructure, for example, are quasi-public goods. Without government investment infrastructure would be very basic limiting economic growth and development. People would suffer from more diseases and industry would be very inefficient without government investment in infrastructure.

Government must intervene to achieve its macroeconomic objectives such as stable and low inflation, low levels of unemployment, and sustainable economic growth. Government **fiscal policy** and **monetary policy** should promote the economic environment necessary for the achievement of these objectives. For example the government may need **contractionary fiscal policy** and **contractionary monetary policy** to reduce inflation in order to increase international competitiveness. To increase **aggregate demand**, investment, employment, and economic growth government may cut taxes and reduce interest rates.

Government intervention in a developing country is necessary to protect infant manufacturing industries in order for them to grow, thereby reducing the country's dependency on the production of primary goods for its export revenue. The government might need to devalue its currency in order to reduce the price of its exports, thereby making them more competitive. **Devaluation**, therefore, may lead to an increase in the country's export revenue.

Through a **progressive taxation** system the government can redistribute income more equally. Tax revenue can be used to provide **transfer payments** to households who are unemployed or unable to work because of disability or ill health thereby reducing **absolute poverty** and **relative poverty**.

## What are the weaknesses of interventionist policies?

Resources must be allocated to the administration and carrying out of government policy. The more a government intervenes the more resources must be given over to the administrative process. For example, protectionist policies such as **quotas**, **tariffs**, and subsidies require many resources if the policy is to be carried out effectively. For example, a firm receiving subsidies must be overseen by government officials to ensure the subsidies are being used for the correct purpose and the government must allocate resources to the administration of nationalized industries. High levels of intervention require the use of many resources. There is a large **opportunity cost** of intervention. The resources are not available to the **private sector**. They cannot be used to produce goods and services. Labour, land, and capital used to carry out and administer government interventionist policies is unproductive, thereby reducing the potential output of the economy.

Import substitution and the supply of **merit goods** such as education, health services, and **quasi-public goods** such as transport infrastructure, require lots of planning and detailed knowledge. Central planners do not necessarily have the skills necessary to effectively carry out policies. They may not know the health needs of particular regions of the country. Planners may not have accurate information about the needs of industry. Lots of resources can be wasted on unnecessary investment projects. Badly needed basic health services may not be provided if the government does not have the correct information. Without accurate information and technical knowledge many of the country's scarce resources will be wasted.

## How does corruption affect efficiency?

**Corruption** occurs when politicians and bureaucrats working for the government use their official public positions to make private gains. Corruption comes in many forms including the acceptance of bribes, fraud, and the theft of public money.

The firm which is employed to build infrastructure is often the one that is prepared to pay the government officials the most money and not the most efficient firm producing at lowest average total cost. Because of corruption, more of the country's scarce resources are used to produce the good than is necessary.

If firms have to bribe officials it increases their costs of production. Average total cost is higher leading to higher prices and a fall in competitiveness.

Public officials can ignore environmental concerns of an investment leading to market failure caused by **negative externalities** in the construction of infrastructure and the production of output.

Well educated and highly skilled people might be attracted to work as public officials because of the benefits available from the power of holding public office. People are maximizers, therefore many will work as public officials instead of working in the private sector. Scarce resources are allocated away from the productive sector to the unproductive sector. It is an inefficient use of labour.

## How does corruption affect investment?

High levels of corruption reduce trust. If international and domestic firms fear that contracts will not be enforced it increases the risk of investment, thereby reducing the amount of external and internal investment in the country.

## How does corruption affect human capital?

Public officials are more likely to allocate resources to the production of large-scale projects than into education and healthcare, because public officials can benefit from the payments large construction firms are prepared to make in order to get the job. Fewer funds are available for investment in education and health.

People have to bribe officials to receive education and healthcare. It acts as a tax on these services, reducing **disposable income** and aggregate demand. Some people on very low income cannot afford to pay the bribe and therefore do not gain the benefits the services provide.

## How does corruption reduce tax revenue?

Lower investment and increases in business costs, because of corruption, limits profits and economic growth and thereby reduces the amount of tax raised by the government. Households and firms can also avoid taxes by bribing tax officials.

### Subject vocabulary

**progressive taxation** a system of taxation in which the rate of tax increases with income

**transfer payments** a payment of money for which nothing is received in exchange

**absolute poverty** occurs when people do not have enough resources to satisfy their basic needs

**relative poverty** a measure of poverty that relates to the average income earned in a country or region. Definitions vary but many governments define it as an income less than 50% of the median income.

**quotas** a physical limit placed on the number of goods that can be traded or produced

**tariffs** a tax placed on imported goods and services

**opportunity cost** the next best alternative forgone

**private sector** the part of the economy that is regulated but not controlled by the state and concerns individuals and groups bringing together the factors of production normally with the aim of making a profit

**merit goods** goods that the government believes will be under consumed left to the free market. Consumption of a merit good may generate positive externalities therefore the social benefit of consumption is greater than the private benefit.

**quasi-public good** goods that share some of the characteristics of public goods but are not fully non-excludable and non-rivalrous. A road is an example. Most roads are free at the point of use but it is possible to make people pay through tolls and when traffic is heavy the amount available to others to use does begin to diminish so there can be rivalry in consumption.

**negative externalities** occur when the production or consumption of a good creates costs that must be paid by third parties. The existence of negative externalities means that social cost is greater than private cost.

**disposable income** household income after direct taxation has been deducted

### Glossary

**corruption** illegal/immoral behaviour particularly by person(s) in power

## Why is good governance a determinant of economic development?

Set out below are some of the characteristics of good governance.

### Political legitimacy

The electoral process must be open for all to participate so that the government can act with the consent of the people that it governs. This will help to increase political stability, thereby promoting internal investment and inward investment that leads to increases in economic growth and development.

### The rule of law

No individual or groups should be above the law. The law must apply equally to everybody in society. All people and all groups must be treated equally and everybody should know what the rules of law are.

### Enforcement of property rights

If foreign and domestic firms do not believe that their property rights will be safeguarded by the government they are much less likely to invest in the country. Doubts concerning the enforcement of property rights increase business uncertainty, making investment much more risky. This leads to less investment taking place. In other words when property rights are not enforced it discourages economic activity. Investment is the most important determinant of economic growth therefore good governance must include the enforcement of property rights.

### Accountability and transparency

Politicians and public officials must be accountable for their actions and decisions. All transactions between the government and the private sector and other institutions must be open and information on transactions should be freely available. This will reduce the level of bribery, thereby reducing firms' costs of production and lowering prices. Opening up contracts to fair competition between firms should ensure resources are allocated more efficiently. Fewer factors would be needed to produce a given quantity of goods.

### The role of the state

The state should provide the opportunity for all to be involved in the political process and the state should work to maximize the benefits of all members of society. The state must create laws that enforce contracts and that allow for fair competition. This will promote FDI and internal investment and the efficient allocation of resources.

### Correction of market failure

The state should correct market failure, caused by negative externalities of production. Public goods and quasi-public goods that are not provided by free markets should be provided by the government, including transport and communication infrastructure and national defence and security. Merit goods such as education and healthcare should be provided by the state so that all members of society can gain the **private benefits** from the consumption of these services and society can gain from the **external benefits**. The state funding of education and healthcare increases the **value of human capital** leading to increases in economic growth and development. State provision of infrastructure is essential for improvements in **productivity** and the promotion of industrialization.

### Human rights

The government should protect the citizens from harm and suffering and ensure weak and vulnerable people in society are not **exploited** by the more powerful. Income should be redistributed so that no one is in **absolute poverty** and **relative poverty** is reduced.

There is a positive relationship between good governance and economic growth and development. Although no country meets all these standards, developed countries are much closer to meeting them than LDCs. Some economists argue that bad governance is the biggest barrier to economic growth and development.

### Subject vocabulary

**private benefits** the benefit firms or consumers receive from their own production or consumption of a good

**external benefits** occurs when the production or consumption of a good causes a benefit to third parties

**value of human capital** a measure of the quantity and quality of the skills of the labour force that can be employed to produce goods and services. An increase in the value of human capital leads to an increase in labour productivity.

**productivity** the quantity of output per unit of input

**absolute poverty** occurs when people do not have enough resources to satisfy their basic needs

**relative poverty** a measure of poverty that relates to the average income earned in a country or region. Definitions vary but many governments define it as an income less than 50% of the median income.

### Glossary

**exploited** making use of something to gain maximum profit from it



## Why might economic development be best achieved through a mixture of government intervention and market-orientated policies?

Most economists and politicians agree that all countries, including developing countries, need a mix of interventionist and market-orientated policies to promote economic development. The reasons for this are set out below.

1. Governments must intervene through fiscal and monetary policy to achieve macroeconomic objectives.
2. Protectionist policies are needed to protect infant manufacturing industries so that LDCs can break their dependency on the production of primary goods for export revenues. Free competition is likely to result in developing countries being unable to break free from the **poverty cycle**.
3. Governments may have to devalue the currency in order to make exports more price competitive.
4. A free market in which everyone pursues their own interest does not lead to an efficient allocation of resources. Governments must intervene to correct market failure caused by **positive externalities** and **negative externalities** and the **free rider problem**. A free market will not provide the infrastructure needed for sanitation and clean water, nor will it provide the transport and communications infrastructure. A free market would lead to under consumption of education and healthcare and under production of infrastructure. Intervention is therefore necessary for economic growth and development.
5. A free market leads to unsustainable economic growth. Without government intervention natural resources would run out and over production of the land would lead to a decline in soil quality (soil degradation). Industrialization would lead to increases in harmful emissions and poor air quality, increasing the external costs of production and the private costs of individuals.
6. A free market leads to a very unequal distribution of income. Governments must use the tax system to redistribute income more equally in order to reduce absolute and relative poverty.
7. Tax rates can be reduced by government to encourage much needed **foreign direct investment**.

However, a balance must be achieved because there are many benefits to be gained from competitive markets.

1. Privatization of state monopolies can reduce the waste of resources. If a firm must make a profit to survive it will try to reduce its average total cost by using resources efficiently.
2. **Deregulation** makes markets more contestable as it opens up markets to competition. This leads to increases in productivity, lower average costs, and greater supply thereby lowering prices and increasing the **purchasing power** of income.
3. The price mechanism leads to **consumer sovereignty**. As demand for goods increase, prices and profits increase, leading to an increase in the supply of the goods consumers want.
4. **Trade liberalization** leads to a fall in prices and increases in efficiency. Consumer welfare increases as consumers pay a lower price and the world's scarce resources are allocated more efficiently because supply comes from the firms that are able to produce at lowest average costs.
5. If countries produce the goods in which they have a **comparative advantage** and then trade, the output from a given quantity of resources will increase and more wants can be satisfied.

### Test your understanding of this unit by answering the following questions

- Explain the inefficiencies caused by corruption and bureaucracy.
- Why is good governance important for economic growth and development?
- Discuss the advantages of trade liberalization, privatization, and deregulation.
- Explain why government intervention is necessary for economic development.

### Subject vocabulary

**poverty cycle** occurs in a country which has low income and therefore low levels of savings. Low levels of savings means little investment can take place and the economy is unable to grow, thus income remains low.

**positive externalities** occur when the production or consumption of a good causes benefits to third parties. The existence of positive externalities means that social benefit is greater than private benefit.

**negative externalities** occur when the production or consumption of a good creates costs that must be paid by third parties. The existence of negative externalities means that social cost is greater than private cost.

**free rider problem** occurs when people are able to benefit from the consumption of a good or service without paying the full price or without paying any money at all. The good will be under-provided or, in the case of a pure public good, not provided at all.

**foreign direct investment** cross-border investment, usually by firms, that involves the acquisition of assets in a foreign country. FDI can be the purchase of a minimum of 10% of the shares of a foreign company but also includes the creation of productive capacity.

**deregulation** removal of government legislation and laws governing particular markets

**trade liberalization** the removal of, or reduction in, the international barriers to trade, such as tariffs and quotas

**comparative advantage** when a country, firm, or individual is able to produce a particular good or service at a lower opportunity cost than other countries, firms, or individuals

### Glossary

**purchasing power** the amount of goods or services that can be bought with a unit of currency

**consumer sovereignty** occurs when firms allocate resources to the production of goods in accordance with the wants of consumers